Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:TL-N-1918-01
AJMandell

date:

to: Associate Area Counsel (LMSB:MCT) Cleveland
Attn: Christopher A. Fisher

from: Associate Area Counsel
(Financial Services: Long Island)

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subject: [redacted]
f.k.a. [redacted]
Inflated Basis Transaction

U.I.L. Nos. 351.00-00, 358.03-00, 897.00-00, 162.00-00, 162.30-00, 212.19-00, 212.21-00, 482.00-00, 6662.00-00.

This memorandum responds to your request for advice regarding a pair of inflated basis loss transactions undertaken by [redacted], f.k.a. [redacted] ([redacted]). This memorandum should not be cited as precedent.

Issues

1. Whether a series of prearranged transactions, culminating in $[redacted] in capital losses and $[redacted] in ordinary losses on the sale of stocks received by the taxpayer in a section 351 transaction, should be disallowed on the following grounds:

a. That the taxpayer failed to substantiate its entitlement to the capital loss. 162.00-00.

b. That the series of transactions in which the taxpayer obtained and sold the assets lacked economic substance. 162.30-00.

c. That the carryover basis in the stock received from [redacted] was derived from lease stripping transactions that lacked economic substance. 9226.00-00.

d. That the capital loss may be allocated from [redacted] to [redacted] under the authority of I.R.C. § 482. 482.00-00.

e. That I.R.C. § 351 does not apply to the exchanges so that [redacted] would recognize gain or loss on the exchange and [redacted] would take a basis in the stock equal to its fair market value. 351.00-00.

f. That the basis in the inflated basis stock acquired in the original section 351 transaction, in the underlying lease strip, is overstated. 358.03-00.

2. Whether the aircraft lease transactions, culminating in an ordinary loss of $[redacted] should be disallowed?

3. Whether the Service can take the position that the accuracy related penalty provided by section 6662 applies to deficiencies that result from adjustments to the capital losses reported by [redacted]? 6662.00-00.

Facts

The facts, as we understand them, are as follows:

The [redacted] Transactions - Prior to [redacted], [redacted] was the common parent of a group of wholly-owned subsidiaries engaged in the manufacture and sale of [redacted] equipment and supplies. [redacted]'s subsidiaries included [redacted] ([redacted]), [redacted] ([redacted]), and [redacted] ([redacted]). The [redacted] shareholders, wanting to sell their stock, brought in [redacted] (f.k.a. [redacted]) to help facilitate a deal. By the Agreement and Plan of Merger (Merger Agreement) dated [redacted], [redacted], [redacted][1] ([redacted]) and [redacted] agreed that on [redacted]:

a. 1) [redacted] would merge into [redacted]; 2) the separate corporate existence of [redacted] would thereupon terminate; 3) [redacted] would continue as the survivor of the merger, as a wholly-owned subsidiary of [redacted]; 4) [redacted] would retain its name; 5) the Corporate By-Laws of [redacted] would replace those of [redacted]; and 6) the officers and directors of [redacted] would replace those of [redacted].

b. The stock of [redacted] would be converted into [redacted] stock and constitute all of the issued and

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[1] [redacted], the promoter, was the sole shareholder of [redacted] at the time of the [redacted] merger agreement.

outstanding stock of [redacted].

c. The previously outstanding shares and warrants to purchase shares of [redacted] stock at the time of merger would be converted into cash and canceled.

d. The funds used to purchase the shares of the [redacted] shareholders was to come from the "Merger Consideration" to be paid by [redacted]. "Merger Consideration" is defined in the Merger Agreement as: 1) $[redacted]; 2) plus the "Debt Increase Amount"; 3) less certain amounts paid by [redacted] (i.e., transaction costs, costs of repurchasing outstanding stock options of [redacted], and certain compensation due to certain executives and board members of [redacted]).

By the Asset Purchase Agreement (Purchase Agreement) dated [redacted], [redacted] and its wholly-owned subsidiaries [redacted], [redacted], and [redacted], agreed to sell most of their assets[2] and transfer most of their liabilities[3] to [redacted] ([redacted]), a wholly-owned subsidiary of [redacted], on [redacted][4]. It is our understanding that [redacted] and [redacted] are otherwise unrelated to any of the parties discussed herein. The purchase price was: 1) $[redacted]; 2) plus the Debt Increase Amount (defined in the Merger Agreement); 3) less the amounts paid by

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[2] The assets which were not sold to [redacted] were termed the "Retained Assets" and included: 1) all of the assets of [redacted] relating to the [redacted] division; 2) all rights of [redacted] pursuant to the company Pension Plan; 3) a warehouse located in [redacted] and 4) the capital stock of [redacted], [redacted] and [redacted].

[3] The liabilities which were not transferred to [redacted] were termed the "Retained Liabilities" and included: 1) all of the liabilities of [redacted] relating to the [redacted] division; 2) all liabilities of [redacted] under its benefit plans; 3) all liabilities of [redacted] under the Merger Agreement; and 4) all tax liabilities of [redacted] and subsidiaries resulting from the Merger Agreement and Purchase Agreement.

[4] Among the assets sold by [redacted] and its subsidiaries to [redacted], was the right to the use of the names [redacted] and [redacted]. Following the sale, [redacted] became known as [redacted] and [redacted] became known as [redacted]. Rather than further complicate the discussion herein, we will continue to use [redacted] and [redacted] to refer to these entities regarding matters which occurred after [redacted].

[redacted] (i.e., transaction costs, costs of repurchasing outstanding stock options of [redacted], and certain compensation due to certain executives and board members of [redacted])[5].

The gain from the sale was reported by [redacted] on its [redacted] return as follows:

Total Sales Price: $[redacted][6]

Gain: Capital: $[redacted]
Ordinary: [redacted]
Total $[redacted]

By various agreements, [redacted] and [redacted] undertook the following alleged section 351 transaction on [redacted]:

a. [redacted] contributed [redacted] shares of [redacted] common stock, [redacted] shares of [redacted] common stock and a $[redacted] promissory note to [redacted] in exchange for [redacted] shares of [redacted] common stock. The property contributed by [redacted] had a combined tax basis of $[redacted] and a fair market value of $[redacted].

b. [redacted], a Delaware Limited partnership, transferred a [redacted]% interest in [redacted] ([redacted]) to [redacted] in exchange for [redacted] shares of [redacted] common stock. The tax basis of the [redacted] interest at the time of the contribution was

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[5]It appears that the original shareholders of [redacted] wanted to sell their stock (but not the assets of the corporation because of the corporate level tax) and [redacted] wanted to purchase the assets of [redacted] (but not the stock because [redacted] wanted a stepped up (cost) basis in the assets). It also appears that the [redacted] shareholders brought in [redacted] to facilitate the deal knowing that [redacted] could buy the corporate stock from the [redacted] shareholders (a bridge loan was used to finance the stock purchase), sell the assets to [redacted], use the proceeds to pay back the bridge loan, and shelter the corporate level tax.

[6] Although the Purchase Agreement identifies the cash portion of the purchase price as $[redacted], it appears that [redacted] used $[redacted] as the cash portion in computing the gain from the sale on its [redacted] tax return. The examining agent is looking into this to determine why [redacted] used the lesser amount in computing its gain.

determined to be $[redacted]. However, its fair market value was determined to be only $[redacted].

Immediately following the above alleged section 351 transaction, [redacted] undertook the following alleged section 351 transactions involving [redacted] and [redacted], also occurring on [redacted]:

a. [redacted] contributed a [redacted]% interest in [redacted] to [redacted] in exchange for [redacted] shares of [redacted] common stock. The tax basis of the [redacted] interest contributed was $[redacted] and its fair market value was only $[redacted].

b. [redacted] contributed a [redacted]% interest in [redacted] to [redacted] in exchange for [redacted] shares of [redacted] common stock. The tax basis of the [redacted] interest contributed was $[redacted] and its fair market value was only $[redacted].

By agreements dated [redacted], [redacted], [redacted], and [redacted] agreed to sell their interests in [redacted] to [redacted] for a combined sales price of $[redacted], thus producing a long term capital loss of $[redacted] ($[redacted]). The loss from the sale of the [redacted] interests offset all but $[redacted] of $[redacted] in long term capital gain reported by [redacted] and subsidiaries on the asset sale to [redacted].

<u>The Aircraft Lease Transactions</u> - By agreements dated [redacted], [redacted] and [redacted] ([redacted]) undertook the following alleged section 351 transaction with respect to [redacted]:

a. [redacted] contributed a $[redacted] promissory note to [redacted] in exchange for [redacted] shares of [redacted] common stock.

b. [redacted] assigned a [redacted]% interest in certain aircraft leases to [redacted] in exchange for [redacted] shares of its common stock and [redacted]'s assumption of liabilities in the amount of $[redacted]. The tax basis of the interest was $[redacted] and but had a fair market value of only $[redacted].

On the same date as the above alleged section 351 transaction, [redacted] sold its [redacted]% lease interest to [redacted] for $[redacted] plus the assumption of the $[redacted] liability contributed to it by [redacted]. [redacted] reported an ordinary loss of $[redacted] on the sale, offsetting most of the $[redacted] ordinary gain realized on the sale of assets to [redacted].

Summary of Tax Effects - [redacted]'s business operations ceased with the [redacted] asset sales on [redacted]. [redacted] remained in existence, however, and filed a [redacted] tax return for the entire [redacted] calendar year. The examining revenue agent was provided with a pro forma tax return for the [redacted] - [redacted] period showing a net loss from operations of $[redacted]. This loss, combined with the $[redacted] in gains from the [redacted] asset sales, the $[redacted] in losses form the [redacted] inflated basis dispositions and $[redacted] in additional expenses not reflected on the [redacted] - [redacted] pro forma tax return, combined to produce a reported net operating loss of $[redacted] for the [redacted] tax year.

Law and Analysis

1a. The Service may challenge the capital loss deduction reported by [redacted] from the sale of its subsidiary's interests in [redacted] to [redacted] on the ground that it failed to substantiate entitlement to the loss.

As set forth above, although the [redacted] interest was valued at $[redacted] and had an alleged basis in [redacted]'s hands of $[redacted], it is our understanding that to date [redacted] has failed to provide any information regarding the [redacted] basis.

It has long been recognized that when taxpayers claim bases carried over from other parties, they are required to prove the carryover bases. Stock Yards National Bank v. Commissioner, 153 F.2d 708, 710-12 (8th Cir. 1946); Boyle Ice Co. v. Commissioner, 33 B.T.A. 420, 425 (1935); James Manufacturing Co. v. Commissioner, 17 B.T.A. 205, 211-12 (1929). The books of the party from whom the basis is carried over do not prove the basis of the assets reflected on them. Fairmont Aluminum Co. v. Commissioner, 7 T.C.M. (CCH) 783, 787 (1948) (reasoning that the balance sheet of predecessor corporation, without more, cannot logically be viewed as proof of basis). A taxpayer is not entitled to basis it cannot substantiate. Stock Yards National Bank v. Commissioner, 6 T.C.M. (CCH) 478, 482 (1947) (citing Burnet v. Houston, 283 U.S. 223 (1931)). Therefore, the claimed loss should not be allowed without the taxpayer providing evidence of its claimed $[redacted] basis.

1b. <u>The Service may challenge the capital loss deduction reported by [redacted] on the ground that the series of transactions in which the [redacted] subsidiaries obtained the [redacted] interests from [redacted] and transferred them to [redacted] lacked economic substance and had no business purpose.</u>

As an alternative ground for disallowing the capital loss, the loss should not be allowable because it appears to emanate from transactions that were entered into solely for the purpose of tax avoidance, have no economic substance or business purpose, and were prearranged and predetermined.

A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. <u>Estate of Franklin v. Commissioner</u>, 64 T.C. 752 (1975); <u>Rice's Toyota World, Inc. v. Commissioner</u>, 752 F.2d 89, 92 (4th Cir. 1985); <u>Frank Lyon Co. v. United States</u>, 435 U.S. 561 (1978). To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved by tax reduction. If a taxpayer seeks to claim tax benefits that Congress did not intend by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance applies. <u>United States v. Wexler</u>, 31 F.3d 117, 122, 124 (3d Cir. 1994); <u>Yosha v. Commissioner</u>, 861 F.2d 494, 498-99 (7th Cir. 1988), <u>aff'g</u>, <u>Glass v. Commissioner</u>, 87 T.C. 1087 (1986); <u>Goldstein v. Commissioner</u>, 364 F.2d 734 (2d Cir. 1966), <u>aff'g</u>, 44 T.C. 284 (1965); <u>Weller v. Commissioner</u>, 31 T.C. 33 (1958), <u>aff'd</u>, 270 F.2d 294 (3d Cir. 1959); <u>ACM Partnership v. Commissioner</u>, T.C. Memo. 1997-115, <u>aff'd in part and rev'd in part</u>, 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. <u>United States v. Cumberland Public Service Co.</u>, 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. <u>Cherin v. Commissioner</u>, 89 T.C. 986, 993-94 (1987); <u>ACM Partnership</u>, <u>supra</u>. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. See also Notice 95-53, 1995-2 C.B. 334.

All of the facts and circumstances surrounding the transactions must be considered. No single factor will be determinative. Courts will respect the taxpayer's characterization of the transactions if there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

The Service was successful recently in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner lacked economic substance. ACM Partnership, 157 F.3d at 231. In ACM Partnership, the Commissioner argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance, and lacking in economic reality. The court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved primarily by tax reduction. It held that the transaction lacked economic substance and, therefore, that the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the court will disregard a series of otherwise legitimate transactions where the Commissioner is able to show that the facts, when viewed as a whole, have no economic substance. See Rev. Rul. 99-14, 1999-13 I.R.B. 3 (because lease-in/lease-out transactions have no economic substance, a U.S. taxpayer may not take deductions for rent or interest paid or incurred in connection with a transaction). See also, Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (1999); United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268 [7]; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999)[8].

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g, 89-9 USTC (CCH) ¶ 9523 (E.D.N.C. 1989); Krumhorn v. Commissioner, 103 T.C. 29, 55 (1994); Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 438 (1985).

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[7]In United Parcel Service of America, Inc., the Eleventh Circuit recently reversed the Tax Court on the issue of economic substance finding that UPS's restructuring of its excess-value business had both real economic effects and a business purpose. The Court reasoned that setting up a transaction with tax planning in mind is permissible as long as there is a bona fide, profit-seeking business purpose. United Parcel Service of America, Inc. v. Commissioner, 2001 U.S. App. Lexis 13926. We do not believe that this opinion will have a negative effect on the instant case because it does not appear that the taxpayer had any business purpose for entering into the transaction. See also footnote 8 below, where the Eleventh Circuit upheld the Tax Court's determination that a transaction lacked economic substance.

[8]The Eleventh Circuit recently affirmed the Tax Court's determination that the transaction entered into by the taxpayer was a substantive sham. Winn-Dixie Stores, Inc. v. Commissioner, 2001 U.S. App. Lexis 14346.

The facts as currently developed appear to support the view that the series of transactions in which the [redacted] subsidiaries obtained and sold the [redacted] stock lacked both objective economic substance and non-tax business purpose. The taxpayer has not provided any information regarding its business purpose for getting and disposing of its [redacted] interest, resulting in a $[redacted] capital loss, in the same taxable year in which it had an approximate unrelated $[redacted] gain. As explained below, [redacted] is the partnership that absorbed the accelerated income in many of the lease stripping transactions promoted by [redacted] ([redacted]). The facts as currently developed suggest that current tax reduction (to offset significant gains from the sale of business assets) was the sole motive for the transactions.[9]

The facts as currently developed have also failed to show that the transactions had any objective economic substance. The inflated basis stock was received by the taxpayer in a purported 351 transaction on [redacted] in exchange for [redacted] shares of its own stock.[10] The taxpayer's subsidiaries sold the stock on [redacted] for a combined total of $[redacted] which resulted in the $[redacted] loss. There must be a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.[11] Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership v. Commissioner, 157 F.2d at 249. No evidence has been presented by the taxpayer as to how it expected to make a profit from the ownership of the stock.

[9]If the taxpayer had a valid business purpose for this transaction, it is likely that an explanation would have already been provided. The credibility of any possible explanations for the investment in and sale of the stock should be investigated further through discovery and other means.

[10]It was actually [redacted] shares of [redacted] stock that was exchanged for the [redacted] stock. Further investigation should be done to ascertain the value of the [redacted] shares of [redacted] stock.

[11]Thus far the taxpayer has failed to provide information regarding all of the transaction costs involved in the transaction.

1c. <u>The Service may also challenge the capital loss deduction reported by the taxpayer on the ground that the basis in the stock from [redacted] was derived from lease stripping transactions that lacked economic substance.</u>

As was discussed above in connection with issue 1b., transactions that are devoid of economic substance are not recognized for federal taxation purposes. <u>ACM Partnership v. Commissioner</u>, 157 F.3d 231, 246 (3d Cir. 1998) (quoting <u>Lerman v. Commissioner</u>, 939 F.2d 44, 45 (3d Cir. 1991)). We note that the basis of the stock that [redacted] transferred to the [redacted] subsidiaries in the purported section 351 transactions appear to be traceable to lease stripping transactions. The Service challenges the tax consequences claimed from lease stripping transactions on the grounds that they lack economic substance. <u>See</u> Lease Stripping Coordinated Issue Paper, 2000 TNT 147-10 (July 21, 2000); Notice 95-53, 1995-2 C.B. 334.

We currently have the following information regarding the origin of the inflated basis stock. [redacted] was a partner in a number of partnerships that were involved in lease strip transactions including having a [redacted]% interest in [redacted] ([redacted]). [redacted] was involved in a minimum of [redacted] lease stripping transactions, including [redacted], [redacted], and [redacted], a case that was audited and ultimately conceded by the taxpayer. [redacted] transferred their interest in [redacted] (which interest had an inflated basis) and other partnerships they controlled to [redacted] for an interest in [redacted].[12] The interests in [redacted] were ultimately transferred to [redacted]'s subsidiaries. If further factual development of the underlying lease strips establishes that they lacked business purpose and economic substance, then [redacted] would have no property, for tax purposes, to contribute or, at least no basis in the assets for [redacted] and its subsidiaries to assume under I.R.C. § 362. <u>See</u>, ILM 200048042 (10/16/2000). If that were the case, then [redacted] would not be entitled to the capital loss it claimed from the stock.

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[12] [redacted] was left with an interest in [redacted] with a basis of approximately $[redacted].

1d. <u>The Service may allocate the capital loss claimed by [redacted] to [redacted] under the authority granted by I.R.C. § 482.</u>

I.R.C. § 482 provides:

> In any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute apportion, or allocate * * * deductions * * * between or among such organizations * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations.

I.R.C. § 482 requires that two or more entities are owned or controlled by the same interests. There does not appear to be common ownership between [redacted] and [redacted]. Therefore, the primary question under section 482 is whether [redacted] and [redacted] may be considered as controlled by the same interests.

The regulations under section 482 define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercised." Treas. Reg. §§ 1.482-1(a)(3) & 1.482-1T(g)(4). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. <u>Id</u>.; <u>Accord Ach v. Commissioner</u>, 42 T.C. 114 (1964), <u>aff'd</u>, 358 F.2d 342 (6th Cir.), <u>cert. denied</u>, 385 U.S. 899 (1966).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3)(1968). The 1993 and 1994 regulations also contain the presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1T(g)(4)(1993); Treas. Reg. § 1.482-1(i)(4)(1994). Thus, joint, legal, or overlapping ownership is not required for unrelated corporations to come within the purview of section 482 if arbitrary income or deduction shifting is present or if there is a common goal to shift income or deductions.

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove section 482 applies by establishing a shifting of income and deductions. Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1390 (5th Cir. 1979), rev'g, 35 A.F.T.R. 2d ¶ 75-394 (N.D. Tex. 1974). It appears that the burden can be met by showing that this was a prearranged transaction, the purpose of which was to transfer to [redacted] or its subsidiaries stock with an inflated basis from which losses might be claimed to offset other gains.

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1)(1968); Treas Reg. § 1.482-1T(a)(2)(1993); Treas. Reg. § 1.482-1(a)(2)(1994). A controlled group or controlled taxpayers are defined to mean the entities owned or controlled by the same interests, and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. §§ 1.482-1(i)(5) &(6)(1994). Unlike the term "control," the phrase "same interests" is not defined in the regulations under Code section 482. Case law as well as the legislative history of Code section 482 provide guidance.

In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals". Brittingham v. Commissioner, 598 F.2d 1375, 1379; H. Rept. No. 2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384. Different persons with a common goal or purpose to artificially shift income can constitute the "same interests" for purposes of the statute. South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967). The phrase "same interests" should not be narrowly construed to frustrate the intent of section 482. Appeal of Rishell Phonograph Co., 2 B.T.A. 229 (1925).

Thus, it is not necessary that the same person or persons own or control each business before section 482 can be applied, but there must be a common design for the shifting of income for different entities to constitute the "same interests". This definition of same interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. If there is a common design for shifting income or deductions, then the requirements for "control" and "same interests" will be met. Hall v. Commissioner, 32 T.C. 390 (1959).

Section 482 has been utilized to reallocate income or losses from an asset that has been contributed to an entity in order to shift gain or loss inherent in the asset. Ruddick v. United States, 3 Cls.Ct. 61 (1983). Ruddick involved a merger between RSD and A&E. RSD had a large net operating loss and realized it was unlikely to generate sufficient income even after the merger to utilize the loss before it expired. Thus, before the merger RSD caused its wholly-owned subsidiary, Ruddico, to distribute as a dividend its portfolio holding the ACC stock in which there was a built-in gain. Shortly after the merger, RSD sold the ACC stock, absorbing the gain with its loss carryovers. The Service argued that the gain from the sale of the ACC stock was taxable to the subsidiary, Ruddico, rather than to RSD. The court found that section 482 applied because the declaration of the dividend was prompted by tax rather than business aims, and a plan to sell the distributed shares already existed.

In addition, section 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, if section 482 is applicable, the Service may allocate income and deductions attributable to an entity's disposition of built-in loss (and gain) property, which it acquired in a nonrecognition transaction to the contributing shareholder. Treas. Reg. § 1.482-1(f)(1)(iii)(1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943).

Based on the facts as currently developed, it appears that [redacted] and [redacted] may have acted pursuant to a common plan to artificially shift built-in losses to [redacted]'s subsidiaries. We believe that the Service should attempt to develop in more detail the facts surrounding how and why [redacted] acquired these assets and why it disposed of them to [redacted]. If the parties acted pursuant to a common plan to artificially shift the built-in loss, the Service would be entitled to reallocate the loss.

1e. <u>The Service may challenge the capital loss reported by [redacted] on the ground that I.R.C. § 351 does not apply to the property exchanges so that [redacted] would recognize gain or loss on the exchange and [redacted]'s subsidiaries would take a basis in the stock equal to fair market value.</u>

An alternative argument that could be made is that the transaction in which [redacted] contributed the interests in [redacted] to [redacted]'s subsidiaries in exchange for their stock did not satisfy the requirements of section 351.

A. <u>Control Requirement</u>

Section 351 provides nonrecognition treatment for transfers of property "by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred." Treas. Reg. § 1.351-1(a)(1). Transferors who contribute property to a corporation at different times may be considered part of a single control group if their "rights have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." <u>Id</u>. For example, two transferors were treated as a group where their transfers of property were made 28 days apart pursuant to a non-binding mutual understanding. <u>See</u> <u>Portland Oil Co. v. Commissioner</u>, 109 F.2d 479 (1st Cir.), <u>cert</u>. <u>denied</u>, 310 U.S. 650 (1940). An existing shareholder will not be considered part of a transferor group if the property it transfers "is of relatively small value in comparison to the value of the stock and securities already owned" by the transferor and "if the primary purpose of the transfer is to qualify under [section 351] the exchanges of property by other persons transferring property." Treas. Reg. § 1.351-1(a)(1)(ii).

In the purported 351 transaction [redacted] contributed [redacted] shares of [redacted] common stock, [redacted] shares of [redacted] common stock and a $[redacted] promissory note to [redacted] in exchange for [redacted] shares of [redacted] stock on the same day that [redacted] transferred a [redacted]% interest in [redacted] to [redacted] in exchange for [redacted] shares of [redacted] common stock. It appears that the control requirements of section 351 have probably been met because the ownership interest of all transferors participating in a single transaction are aggregated. Subject to certain limitations, to determine control a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. A control group may consist of any combination of corporations, partnerships, estates, trusts, individuals or associations that transfer property to a corporation in related transfers and which, in the aggregate, control the transferee corporation immediately after the last transfer. Treas. Reg. section 1.351-1(a).

B. Business Purpose Requirement

Courts have held that a transaction meeting the statutory elements of section 351 does not qualify for nonrecognition if it lacks a non-tax business purpose. Caruth v. United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983).

In Caruth, the taxpayer transferred stock in a closely held corporation to his wholly owned corporation four days before the closely held corporation declared a large dividend. The government argued that the dividend should be recognized by the taxpayer because his transfer of the closely held stock to his wholly owned corporation had no business purpose. The taxpayer argued that section 351 did not require a business purpose. The Court's opinion traced the development of section 351 and concluded that the provision is tied very closely to the corporate reorganization provisions. On that basis, the court reasoned that the principles applicable to reorganizations were equally valid for transfers of property to a controlled corporation under section 351.

In Kluener v. Commissioner, T.C. Memo. 1996-519, aff'd, 154 F.3d 630 (6th Cir. 1998) the taxpayer sold his thoroughbred horses to raise funds to meet loan obligations. He first transferred the horses to his wholly owned corporation, which then sold the horses at auction. The corporation reported the sale of the horses on its tax return but offset the gain with a loss carryover. Rather than use the proceeds for its own purposes, the corporation held the funds in a separate account for several months and then distributed the entire amount to the taxpayer, who used part of the funds to pay loans and loaned part back to the corporation. The Tax Court held that, in substance, the taxpayer sold the horses using the corporation as a conduit.

On appeal, the Sixth Circuit affirmed. In discussing section 351, the Court summarized the application of the business purpose requirement by noting that a shareholder's transfer of property to his closely held corporation is not taxed "if the transfer occurred for a valid, non-tax business purpose" but that the Code will tax a shareholder who transfers property solely to avoid taxes.

The Court in Kluener identified the standards used to determine whether there is a business purpose for a transfer. These factors include:

> Whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayer's expertise in tax matters; and the transactions' form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a prearranged plan.

154 F.2d at 635.

As discussed above, the facts as currently developed do not suggest a plausible business purpose for the transactions. There is no indication that the taxpayer has even attempted to argue that it had a valid business purpose.

If section 351 does not apply to the transactions, the transfers would be taxable exchanges under section 1001. [redacted]'s basis in the stock would be determined under section 1012.

1f. The basis in the inflated basis stock acquired in the original 351 transaction (in the underlying lease stip) is overstated.

As set forth in the Technical Assistance dated March 13, 2001 (SPRO-105569-00), depending on the facts that may be developed with regard to the lease strip transactions, additional arguments can be made that the application of section 358(d)(1) will reduce the basis by the amount of any liability (usually the obligation to pay rent) that is assumed in the underlying 351 transaction that created the inflated basis.[13] The assumption of the liability would be within the scope of section 357, and under sections 357(a), 358(a)(1)(A)(ii), and 358(d)(1), the basis of the stock received must be reduced by the amount of the liability assumed. As explained in the CCA, the Service should reject any argument that the obligation to pay rent is a liability described in section 357(c)(3)(A), and that, therefore, the assumption of the liability does not reduce the stock basis by reason of section 358(d)(2).

Two additional potential arguments (set forth in the CCA) could also be made. Even if the assumption of the lease obligations would otherwise be within the scope of sections 357(c)(3) and 358(d)(2), the assumption should be treated as a distribution of money under section 357(b) and therefore should reduce the stock basis under section 358(a). In addition, an argument could be made that the transaction is not a bona fide loss under section 165.

2. <u>The Service should be able to challenge the $[redacted] ordinary loss claimed by [redacted] in the transaction involving the aircraft lease.</u>

As set forth above, on [redacted], [redacted] contributed a $[redacted] promissory note to [redacted] in exchange for [redacted] shares of [redacted] common stock and [redacted] assigned a [redacted]% interest in certain aircraft leases to [redacted] in exchange for [redacted] shares of its common stock and [redacted]'s assumption of $[redacted] in liabilities. The tax basis of the interest was $[redacted] and the fair market value was only $[redacted]. On the same day as that alleged 351 transaction, [redacted] sold its [redacted]% interest to [redacted] for $[redacted] plus the assumption of the $[redacted] in liabilities. [redacted] reported an ordinary loss of $[redacted] offsetting most of the $[redacted] ordinary gain realized on the sale of assets to [redacted].

We do not currently have enough information to determine the basis for the taxpayer's claim that it is entitled to any ordinary loss. Additional facts should be developed regarding the origin of the aircraft leases, including the owner of the underlying assets and the end

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[13]These transactions occurred before October 19, 1999 and therefore section 358(h) would not be applicable.

user(s). If possible, all documents relating to the leases should be secured. It is possible, based on the information that is received, that the Service could make many of the same arguments for disallowing the ordinary loss as was made in disallowing the capital loss, including simply that the taxpayer has failed to prove that it incurred the claimed loss. In addition, it is unlikely that the taxpayer will be able to prove that it had a nontax business purpose for entering into the transaction when it received and sold the interest in [redacted] on the same day. The taxpayer should also be required to show that it met the technical requirements of section 351, including the control and business purpose requirements.

3. <u>The accuracy related penalty provided by Code section 6662 applies to deficiencies that result from adjustments to the losses reported by [redacted] from its disposition of the stock received in the purported section 351 transaction.</u>

Code section 6662(a) imposes a penalty in an amount equal to 20 percent of the underpayment of tax attributable to one or more of the items set forth in Code section 6662(b). The items set forth in Code section 6662(b) include, as is relevant here, negligence, substantial understatements of income tax, and substantial valuation misstatements under chapter 1.

<u>Negligence</u> - "Negligence" includes a failure to make a reasonable attempt to comply with provisions of the internal revenue laws or failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. <u>See</u> I.R.C. § 6662(c); <u>Martello v. Commissioner</u>, 380 F.2d 499, 506 (5th Cir. 1967), <u>aff'g on this issue</u>, 43 T.C. 168 (1964); Treas. Reg. § 1.6662-3(b)(1). A return position that has a reasonable basis is not attributable to negligence, but negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances[.]" Treas. Reg. § 1.6662-3(b)(1). The accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion of an underpayment and that the taxpayer acted in good faith with respect to such portion. <u>See</u> I.R.C. § 6664(c)(1). The determination of whether the taxpayer acted with reasonable

cause and in good faith depends upon the pertinent facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to assess the proper tax liability for the year. See Id. The negligence penalty can be applied to deficiencies resulting from the application of the economic substance doctrine. Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 226-27 (1999).

Here, the facts developed support the view that the accuracy-related penalty applies to the deficiency that results from the disallowance of the built-in losses from the inflated basis assets because [redacted] disregarded the economic substance of the transactions from which the losses were claimed and has failed to offer evidence that there was reasonable cause for its return position for the losses or that it acted in good faith in claiming them. Many of the "players" involved in the transactions were individuals with a history of involvement in lease stripping transactions, and either knew or should have known that the Service had issued Notice 95-53 stating that it intended to challenge lease stripping transactions such as those from which the inflated bases of the stock were derived. There is no evidence that they thoroughly investigated the bona fide economic aspects of the lease stripping transactions or reasonably relied on professional advice that the losses are allowable. See Freytag v. Commissioner, 904 F.2d 1011, 1017 (5th Cir. 1990); Treas. Reg. § 1.6664-4(c). We accordingly conclude that the facts as currently developed support the conclusion that [redacted] was negligent and that the penalty provided by Code section 6662(a) should be applied.

Substantial Valuation Misstatement - A substantial valuation misstatement exists if the adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such adjusted basis. I.R.C. § 6662(e)(1)(A). The circumstances in which a valuation misstatement exists include the circumstance when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). Here, if the Service prevails on its challenge to the basis reported by [redacted] in the stock it received in the purported section 351 transaction, we believe the penalty provided by Code section 6662(a) would apply on the grounds that a substantial valuation misstatement would exist. If the basis [redacted] claimed was 400 percent or more of the amount determined to be the correct basis, we believe the penalty would be 40 percent of the underpayment. See I.R.C. § 6662(h).

Substantial Understatement of Income Tax - A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. I.R.C. § 6662(d)(1)(A). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B). However, those reductions do not apply to items of corporations attributable to tax shelters. I.R.C. § 6662(d)(2)(C)(ii). Tax shelter means, as is relevant here, any plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii).

We believe that the facts currently developed support the position that the series of transactions in which [redacted] and its subsidiaries acquired and sold the inflated basis stock to recognize the built-in losses was a tax shelter. As was previously stated, the facts suggest that the purpose of the transactions was to generate losses to offset gains from the sale of the [redacted] assets and do not suggest a business purpose for the transactions. In these circumstances, we believe that any understatement that resulted from the disallowance of the loss claimed from the preferred stock would, if substantial, be subject to the penalty provided by Code section 6662(a) unless the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. As was discussed above in connection with negligence, the facts as currently developed do not satisfy even the lower reasonable basis standard that applies for purposes of determining negligence. See Treas. Reg. § 1.6662-4(d)(2).

Moreover, we believe that any understatement that resulted from the disallowance of the loss claimed from the inflated basis assets would, if substantial, be subject to the penalty provided by Code section 6662(a) even if the series of transactions in which [redacted] acquired and sold the inflated basis assets to recognize the built-in losses was not a tax shelter. If the transactions were not a tax shelter, the understatement would be reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B). Neither of those exceptions appears to apply. The substantial authority standard is higher than the reasonable basis standard. Treas. Reg. § 1.6662-4(d)(2). As was discussed in connection with negligence, the facts as currently developed do not support a conclusion that [redacted] had even a reasonable basis for claiming the inflated basis. In addition, it does not appear that the relevant facts affecting the items' tax treatment were disclosed in the return of [redacted] or in attached statements.

Please note that under procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Any questions regarding this advice should be referred to Andrew Mandell at (516) 688-1711.

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